Supplement

The Asian Currency Crisis and the Chinese Economy

1. Are Rumors of Devaluation of Renminbi True?

Speculation is rampant that the Asian financial and currency crisis – which had its epicenter in Thailand and subsequently spread to Indonesia, Malaysia, South Korea, and Hong Kong – will strike China as well. At present, the Chinese economy does not appear to have been affected in any way. The belief that it is only a matter of time before China decides to devalue the renminbi stubbornly persists in Japanese business circles, however, despite repeated denials by the Chinese government. Here, let us examine this assertion and attempt to determine where the Chinese economy will head in the future.

The reasoning behind the belief that China will devaluate its currency runs generally as follows:

(1) The current Asian currency crisis was caused by China's devaluation of its currency 33 percent on January 1, 1994 and China's subsequent takeover of the exports of the Southeast Asian countries.

(2) Therefore, the fall in the value of the Southeast Asian currencies on the exchange markets will result in the Chinese export markets being taken back.

(3) Accordingly, China will decide to devaluate its currency to increase its own exports.

This reasoning, however, is based on some misunderstandings of the Chinese economy. Let us examine them one by one.

2. Is Switch to a Single Exchange Rate in China Cause for Asian Currency Crisis?

First, regarding point (1), Hiroshi Honkawa studied the trends in American and Japanese imports from four ASEAN nations and China and found that Chinese exports could only be said to have hurt ASEAN exports in a few product areas such as furniture and radios to the United States and plastic goods to Japan[1]. In fact, in around 1990, the level of wages in terms of US dollars paid in foreign ventures were two to four times that in South China. Therefore, companies viewed China and the ASEAN countries differently even before China devalued its currency. Japanese companies were shifting their production of apparel, for example, to China since they could no longer make a profit in the ASEAN countries due to the high wages there and were using Thailand and Malaysia as bases for export of higher value added products such as color televisions to Europe. It is true that China tremendously increased its share of exports of apparel over the ASEAN countries in the 1990s, but this did not begin at the change of the exchange rate in 1994 but started before that. The reason for China's increased share was its low wage costs – one-half that of even the Philippines.

Further, the Importance of the January 1, 1994 reduction in the exchange rate of China has to be considerably discounted. First of all, up to the end of 1993, China had been using two exchange rates: the official rate of US$1=5.8 rmb and a market rate at its "foreign currency adjustment center", of US$1=8.7 rmb. The share of the latter had gradually been growing. As of late 1993, 80 percent of trade was reportedly being settled using the market rate. The "reduction of the exchange rate of January 1, 1994" was the abolition of the old official rate and establishment of an exchange market at the location of the old "foreign currency adjustment center" or the de facto merger of the two systems and use of a single exchange rate, that is, the market rate. If it were true that 80 percent of trade had been settled at the market rate even before that, then the actual reduction in the exchange rate amounted to only 7 percent. Further, while China was hit by 22 percent and 15 percent inflation in 1994 and 1995, the nominal exchange rate rose from US$1=8.7 rmb to US$1=8.3 rmb. According to our calculation, the real effective exchange rate rose by 20 percent up to the first quarter of 1997 (see Chapter 6).

Our interpretation of point (1) is as follows: It is a fact that China secured a higher rate of growth of exports of apparel, toys, and other items than the ASEAN countries in the 1990s and that China took over at least part of the growth sectors of the export markets from them. The main cause of this, however, was not the establishment of the single exchange rate by China on January 1, 1994.

3. Will China's Exports be Hurt by Fall in ASEAN Currencies?

Regarding point (2), it is necessary to bear in mind that the main exporters from both China and the ASEAN nations are Japanese and other foreign ventures there. If the plunge in the value of the ASEAN currencies on the exchange markets were to trigger a massive shift of production facilities to the ASEAN countries by companies exporting from China, then perhaps the situation envisioned in point (2) would occur. Would this be really happening however? An episode often cited to back up the assertion of point (2) is that of Thailand's CP Group. The CP Group had been developing China as a base for exports of chicken, but has switched emphasis to exports from Thailand again after the collapse of the currency. Companies like the CP Group which start out with bases for exports of the same products in China and the ASEAN countries can easily adjust the volumes of exports from the two in accordance with currency fluctuations. Most companies, however, are not so positioned and would have to start from scratch if shifting their export bases to ASEAN. With the future of the ASEAN currencies and economies still murky, most companies would probably not make such decisions. In view of this, at least considering 1998, it is difficult to believe that ASEAN will take over export markets from China. If the currency crisis ends with the ASEAN currencies remaining low in value for several years, some companies might then decide to move their export bases there.

Further, note must be taken that there exists a certain amount of "stickness" in the export bases of China. For example, in the case of apparel, in the East China region of Jiangsu province, Shanghai, and Zhejiang province, not only are there many Japanese apparel factories, but also there are many Japanese manufacturers of apparel accessories and textiles, factories turning out fabric and chemical fiber, and so on – all of which moved there together with the apparel makers. The supply capabilities of Japanese ventures in the East China region means East China offers ventures the additional benefit of easy access to materials in addition to the simple low level of wage costs. This being the case, just because the exchange rate is relatively high, companies are not going to move their export bases to other regions.

Naturally, the ASEAN countries are going to become more competitive in areas where Chinese and ASEAN exports competed before the currency crisis. As explained above, however, with wage costs two to four times different, China and the ASEAN countries probably had developed their own niches in the export markets.

The collapse of the Asian currencies will probably impact on the Chinese domestic market more. China has been importing considerable amounts of chemical fiber, finished steel, and machinery from South Korea and Taiwan and household electrical appliances from Thailand and Malaysia in recent years. The plunge in the ASEAN and South Korean currencies will strengthen those countries' competitiveness in exports to China and may further aggravate the difficult conditions which the SOEs are already in.

Our interpretation of point (2) may be summarized as follows: The collapse of the ASEAN currencies will not have an effect on Chinese exports in the short term. Rather, by strengthening the competitiveness of ASEAN and South Korean exports to China, it may intensify competition in the Chinese domestic market and cause the performance of the SOEs there to further deteriorate.

4. Will China Decide to Lower its Exchange Rate?

First, let us look at China's international balance of payments (Table). China, unlike the ASEAN countries, has recorded a surplus on its current account balance almost every year in the 1990s. While exact data on the international balance of payments in 1997 is not yet available, exports have grown 20.9 percent from the previous year and imports 2.5 percent – giving China a trade surplus of US$40 billion. Therefore, China probably recorded a surplus on its current account balance in 1997 as well. Further, since 1993, foreign direct investment has flowed into the country to the tune of US$30 to 40 billion a year, so the capital account balance is also considerably in the black. In 1997, over US$40 billion of foreign direct investment flowed into the country. Since the overall balance (=

Table. China's International Balance of Payments

(million US dollar)

	1990	1991	1992	1993	1994	1995	1996	Jun.1997	Oct.1997
Current account balance	11,997	13,272	6,401	-11,609	6,908	1,618	7,243		
Trade balance	9,165	8,743	5,183	-10,654	7,290	18,050	19,535		
Capital account balance	3,255	8,032	-250	23,474	32,645	38,674	39,966		
Net inflow of direct investment	2,657	3,453	7,156	23,115	31,787	33,849	38,066		
Net inflow of portfolio investment		235	-57	3,049	3,543	789	1,744		
Other net inflow	839	4,344	-7,349	-2,690	-2,685	4,035	156		
Error and omissions	-3,205	-6,767	-8,211	-10,096	-9,100	-17,823	-15,504		
Overall balance	12,047	14,537	-2,060	1,769	30,453	22,469	31,705		
Foreign debt balance	52,545	60,561	69,321	83,573	92,806	106,590	116,275		
Long term loans	45,779	50,257	58,475	70,027	82,391	94,674	102,167		
Short term loans	6,766	10,304	10,846	13,546	10,415	11,916	14,108		
Foreign currency reserve balance (end of period)	28,594	42,664	19,443	21,199	51,620	73,579	105,029	120,941	137,897

Source: IMF, *International Financial Statistics* and *Zhongguo tongji nianjian* (China Statistics Yearbook).

current account balance + capital account balance + error and omissions) is so much in the black, there had been upward pressures on the renminbi starting in 1994. The fiscal authorities were able to keep the renminbi from rising on the exchange markets by intervening to buy up dollars and sell off the renminbi. As a result, the central bank had built up as much as US$140 billion in foreign exchange reserves by the end of 1997. The upward pressure on the renminbi continued even after the Thai currency crisis began in July 1997 and the foreign currency reserves grew. In January 1998, the renminbi rose to the highest level since the establishment of the Chinese exchange market in 1994, that is, US$1=8.2784 rmb.

It is conceivable that "expectations" have an effect on the exchange rates in addition to substantive factors such as the current account balance and foreign direct investment. Still, in this respect, since China has still not liberalized capital transactions, there is little room for speculative transactions in the renminbi. As seen in the attached table, in the capital account balance, there is relatively little "portfolio investment" or "other" inflow. Since the renminbi is still not being bought up, there is no fear of its being dumped.

An episode which tends to be talked about as backing up the assertion of an upcoming devaluation of the renminbi is the reappearance in 1998 of the black market in the exchange of the renminbi and U.S. dollar – which had supposedly disappeared in 1994[2]. There is nothing strange about the appearance of this black market in view of the still strong controls over transactions in foreign currencies. In fact, reports that it had disappeared in 1994 are doubtful. On top of this, the black market rate for the dollar is supposedly just 3 to 4 percent higher than the official rate, which is just the equivalent of a "handling fee" for the black marketeers. There are no grounds for the belief that the renminbi is high in the current exchange rate.

In relation to this, note should be taken of the "error and omission" in the attached table. In 1996 alone, US$15.5 billion worth of foreign currency revenue disappeared somewhere. This undoubtedly includes a considerable amount of capital flight such as black market foreign currency deposits by Chinese nationals. If the "error and omission" were to grow so much as to engulf the surplus on the current account balance or capital account balance due to "expectations", there would indeed be downward pressure on the renminbi, but there is little chance that it will grow that much.

As seen above, there are no outstanding factors right now which would push the renminbi down. The renminbi may be deliberately lowered, but to do this, the fiscal authorities would have to intervene heavily on the foreign exchange market to buy dollars and sell renminbi. The central bank will try to avoid this scenario at all costs since it would increase the money supply.

While there is no economic pressure warranting devaluation of the renminbi, there is political pressure. The rise in the real effective exchange rate of China and the reduction in the rate of refund of the value added tax upon export are disadvantageous to exports of products made using materials produced in China such as cotton and silk fabrics. The main exporters of these goods are the state-owned enterprises. In 1996, exports of the state-owned enterprises dropped as much as 13 percent. Further, as explained above, South Korean and ASEAN goods may be expected to flood the Chinese market. This will also impact on the state-owned enterprises. Accordingly, there is a possibility of growing demands from the SOEs for devaluation of the renminbi. The government cannot afford to completely ignore this.

On the other hand, devaluation of the renminbi would be tremendously disadvantageous to China on the diplomatic front. With point (1) being already believed to a certain extent in the market, devaluation of the renminbi would fuel further sale of the ASEAN currencies and might spark a downward spiral in currency values. The Chinese government has been trying to score diplomatic points by declaring that maintaining the renminbi value as a bulwark against the Asian currency crisis and keeping it from falling below the current rate is the "best support China can provide to Southeast Asia, Hong Kong, and South Korea"[3]. China will further be forced to strengthen support to ASEAN in view of Taiwan's use of its abundant foreign currency reserves to stage a diplomatic offensive aimed at the Asian countries in the midst of this crisis.

While there may be mounting cries of pain from domestic SOEs, China is not likely to devalue the renminbi judging from its current international balance of payments and diplomatic commitments. Seen in the medium term, the renminbi may fall in value. In 1998, China anticipates 8 percent or so growth, but the SOEs are feeling a considerable recession. With the inflation rate held at the 2 percent level, there is strong pressure for policies to boost overall demand. If the Chinese government decides to stimulate the domestic economy and investment and consumption grow, the current account balance may go into the red like it did in 1993. On the other hand, the number of new contracts for foreign direct investment reportedly dropped considerably in 1997. The net inflow will therefore gradually become smaller. If the surplus on the overall balance becomes smaller in this way, the renminbi may fall in value after 1999.

Learning from the current Asian currency crisis, the Chinese government may slow the pace of liberalization of the capital markets. As much as 25 to 30 percent of the outstanding loans of Chinese banks are rumored to be bad. If capital flows in and then is pulled suddenly out like in Thailand's case, the fragility of the financial institutions will be exposed all at once and a financial crisis may be precipitated. If capital is not liberalized, however, the chances to attract foreign capital to business opportunities will be limited. China may be able to avoid a situation like the current crisis by proceeding with liberalization while disclosing full information, including problems regarding its financial institutions, so as not to give investors any mistaken impressions. We would like to study this issue further.

Notes:

1. HIROSHI HONKAWA, "Chugoku: nogarerarenai ajia no tsuka kiki no eikyo" (China: Unavoidable Effects of Asian Currency Crisis), MITSUO FUKUSHIMA and MITSUO TAKII ed., *97 nen ajia tsuka kiki* (1997 Asian Currency Crisis), Institute of Developing Economies 1997.
2. *Nihon Keizai Shimbun*, January 21, 1998.
3. *Nihon Keizai Shimbun*, January 22, 1998.